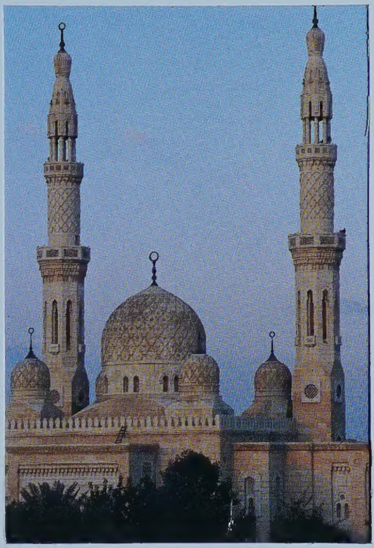


KAPPA ENERGY COMPANY INC

1996

Annual

Report

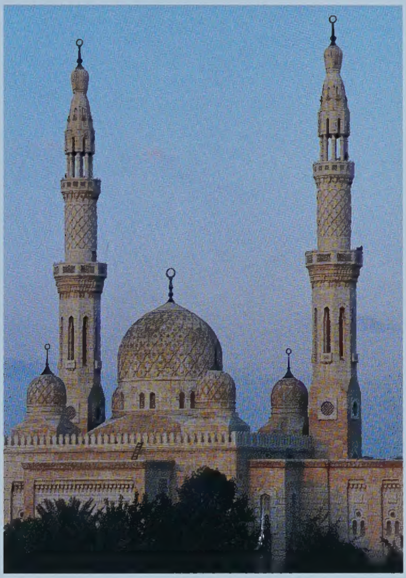
CORPORATE HISTORY

In 1993, the founding shareholders of KAPPA established an energy company to pursue oil and gas projects internationally. As a result, the founders successfully negotiated an interest in the Al Ma'ber Block 2 concession in the Republic of Yemen. Subsequently, KAPPA Energy Company Inc. was incorporated in 1995 to continue and expand the business plan. The founding shareholders of KAPPA are Rick Orman, former Alberta Minister of Energy, together with well-known oil and gas businessmen Michael Kanovsky, Angus Mackenzie, Daryl (Doc) Seaman, Byron (B. J.) Seaman, Donald Seaman and lawyers Jim Palmer and Gerald Regan.

KAPPA became a public company in October 1996 after a reverse takeover resulting in the acquisition of all the common shares of Keltey Energy Limited. KAPPA currently has 17.5 million shares, issued and outstanding, trading on The Alberta Stock Exchange under the symbol "KAP".

ANNUAL AND SPECIAL GENERAL MEETING

The Annual and Special Meeting of Shareholders will be held on Wednesday, May 21, 1997 at 3:00 p.m. in the Cardium Room, Calgary Petroleum Club, 319 - 5th Avenue S.W., Calgary, Alberta.



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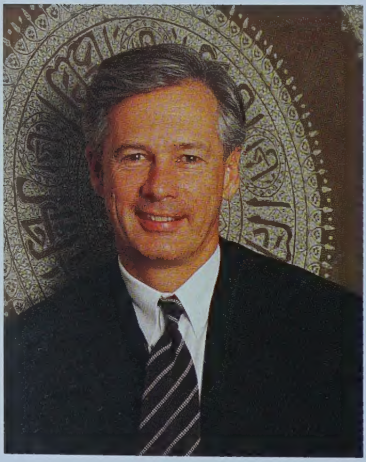
Board of Directors: (left to right) Angus Mackenzie, Rick Orman, Michael Kanovsky, Byron J. (B.J.) Seaman, Grant Emms appointed Director March 1997 (absent)



Rick Orman
Chairman,
Chief Executive Officer, and
Director

Grant Emms
President,
Chief Operating Officer, and
Director

Angela Lau
Chief Financial Officer

LETTER TO SHAREHOLDERS

These are exciting times of unprecedented opportunity for KAPPA and its shareholders. The primary focus during the past year was on building a solid foundation for KAPPA's future growth. Our activities over the past year have positioned KAPPA to take the next quantum leap with the spudding of the first well in 1997, targeting the prolific Qishn sandstone in the Al Ma'ber Block 2 in Yemen.

Important initiatives were taken to bring together the financial and technical resources needed to move forward and strengthen the Company's strategic position in Yemen.

During 1996, KAPPA completed private placements of $9.3 million and the public listing of KAPPA's shares. Successful private placements of common shares in late 1995 and in 1996 raised $2.5 million and $6.8 million, respectively, at share prices of $0.83 and $1.33. After completing a reverse takeover of Keltey Energy Limited and a share consolidation in October 1996, KAPPA's common shares began trading on The Alberta Stock Exchange under the symbol "KAP". KAPPA traded approximately 6 million shares between October 18, 1996 and April 7, 1997, with prices ranging from $1.35 to $2.75 and closed on April 7, 1997 at $2.60.

Prior to KAPPA's involvement, Phase 1 of the Yemen exploration program was completed in 1995 by the original partners of the project and involved the acquisition of 2,007 kilometers of seismic data together with the drilling of four wells, including the Al-Hijera 1 well which encountered oil within the Qishn formation. KAPPA believes this well is a by-passed oil discovery.

Effective December 1995, KAPPA was appointed operator for the Phase 2 program which runs until May 1998. The second phase Minimum Work Program requires a further 250 kilometers of seismic acquisition and the drilling of one exploratory well.

Since assuming operatorship KAPPA mapped the surface geology and completed the reprocessing of the previously existing seismic data by October 1996. A seismic program was shot in the first quarter of 1997 to finalize the first drilling location and evaluate additional prospects.

The past two years have been exceptionally challenging and rewarding for KAPPA. KAPPA has responded positively to the challenges of being operator of Al Ma'ber Block 2 by continuing to build its operational capability and technical competence. With the track record built in Yemen, KAPPA has set the stage for future growth.

1997 Outlook

The acquisition of seismic data on Block 2 commenced in 1997 and will be processed and interpreted by the end of the second quarter of 1997. The results will allow KAPPA and its joint-operating partners to commence drilling its first commitment well, Al-Hijera 2. Recent work from extensive geological and geophysical interpretations, including the use of satellite imagery, suggests the possibility of additional structures and numerous stratigraphic traps.

Jim Bryan with local children in Yemen

As a parallel ongoing effort to operations on Block 2, KAPPA is intensifying its new ventures program. Beyond the Yemen project, growth through international projects which draw upon KAPPA's unique expertise in the technical and political arena will be the cornerstone of our activity.

Our immediate goal is to secure an international producing base and a balanced portfolio of exploration and strategically attractive development projects. To this end, our strategy is to build a team that combines technical excellence with commercial and political acumen. This team will enhance our operational capability, enable KAPPA to capture other high quality projects, and give us the ability to internally generate new projects.

The implementation of this strategy has recently been accelerated with the addition of Grant Emms as President, Chief Operating Officer on March 18, 1997. Mr. Emms brings to KAPPA twenty-one years of expertise in international exploration and production from around the world through his tenure with Amoco Production Company and Canadian Occidental Petroleum Ltd. Most recently, Mr. Emms was Vice President of Exploration and Production for Asia/Latin America and the Commonwealth Independent States for Canadian Occidental Petroleum Ltd. and prior to that directed the exploration and development drilling program in Yemen as Vice President, International Exploration. Mr. Emms' technical, operational and commercial experience will be used to manage the Block 2 program, identify new opportunities and build the KAPPA team.

Sana'a, capital city of The Republic of Yemen

I am extremely grateful for the support of KAPPA's founding shareholders and esteemed Board of Directors. I would also like to thank our many new shareholders for their confidence and support along with our employees in both Canada and Yemen.

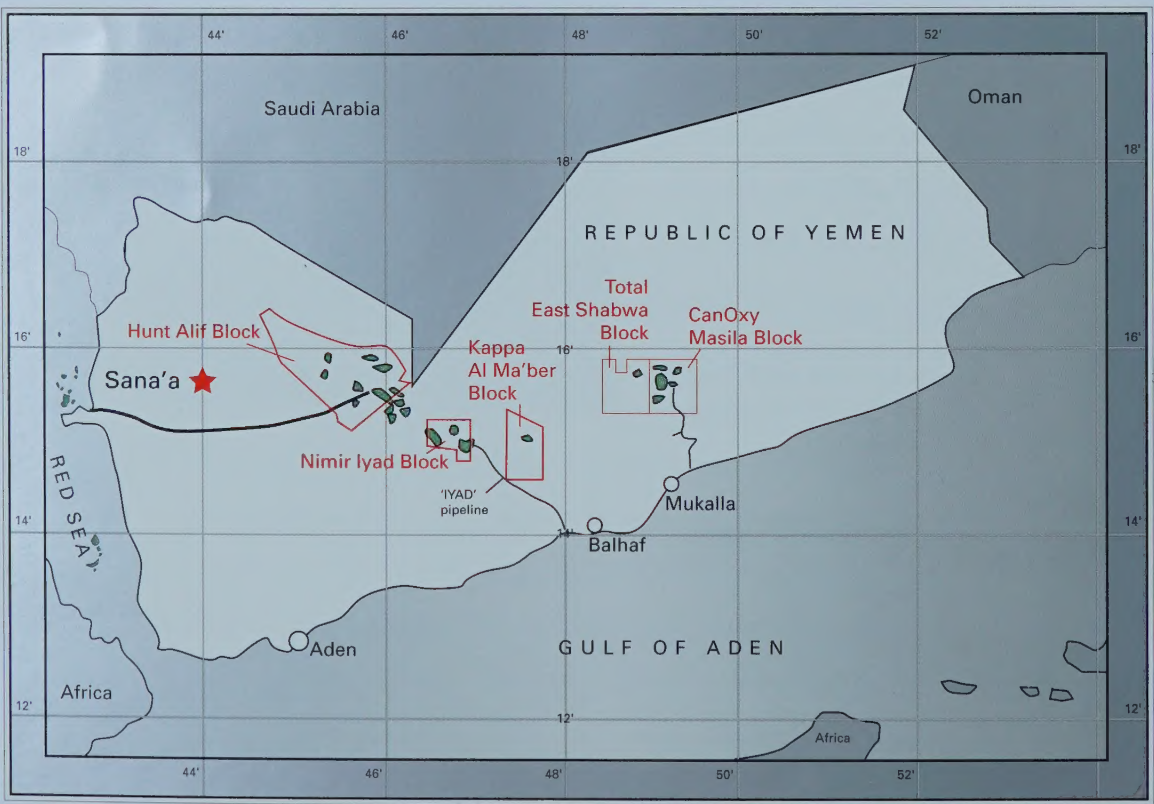
Rick Orman
Chairman and Chief Executive Officer

April 7, 1997
Calgary, Alberta Canada

Yemen Operations

To date, KAPPA's major operational focus has been its majority interest in and operatorship of the Al Ma'ber Block 2 property in Yemen.

Block 2 covers approximately 750,000 acres in central Yemen and is located between the two primary producing properties in the country, each producing in excess of 170,000 barrels of oil per day. The primary target formation in KAPPA's program is the prolific Qishn sandstone that was encountered in previously drilled exploratory wells on the Block. Analysis of the Qishn reservoir properties encountered on Block 2 indicate that the potential reservoir zones are of similar quality to those of the producing fields on the Masila Block to the east. Two other elements critical to exploration success in Yemen also exist on Block 2. As proven by success and failure analysis on and around the Masila Block, the presence of a source rock filled rift graben immediately adjacent to the potential traps is critical to the success of exploratory wells as long distance oil migration has not been proven to be successful in Yemen. The primary prospects on Block 2, including the by-passed producer Al-Hijera 1, lie along the edge of the Shabwa Graben with a working source system as proven by the presence of 28 degree API oil in the well. The second additional element is the presence or absence of salt between the source rock and the Qishn reservoir that could



prevent the migration of oil into the prospects. Block 2 is ideally situated as the salt zero edge passes through the Block in an ideal location to permit the charging of the primary prospects.

Independent engineering reports prepared in 1996 estimate unrisked gross potential oil reserves to be greater than 300 million barrels, with secondary prospects having an additional 200 million barrels of potential.

The Iyad pipeline, which runs from the Nimir operated fields to the west of Block 2 to an export facility on the southern coast, passes through the southwest corner of Block 2. This pipeline has a capacity of 100,000 barrels per day and is available for KAPPA's transportation needs. The existence of this pipeline means that any discovery on Block 2 can be developed on a far lower dollar per barrel basis.

CGG *seismic vehicles*

An extensive seismic database consisting of over 2,000 kilometers of data was acquired by KAPPA with the Block. This has been augmented with a 240 kilometer infill vibroseis program that was acquired during the first quarter of 1997. A 30 kilometer heliportable seismic program will be acquired and processed in April 1997 to complete the coverage on the two key prospects in the areas that were impossible to access with vibroseis due to rough terrain. A final data set and prospect maps are expected to be ready in early May 1997.

1997 Operational Plan

Interpretation of the 1997 vibroseis data received to date confirms the prospectivity of the Al-Hijera and South Ma'ber prospects. The heliportable seismic is required only to finalize the optimum drilling locations on the structures.

KAPPA, as operator, plans to propose these prospects and drilling locations to the Block 2 joint venture partnership in May 1997 and expects Yemen government approval for our first exploratory well in June 1997. KAPPA is considering the merits of both a one and two well drilling program, and expects to spud the first well in the fourth quarter of 1997.

PROJECT DEVELOPMENT

KAPPA is entering into a new phase of project development in 1997. For the past two years, KAPPA has concentrated the majority of its efforts on the advancement of the Yemen project. At the same time, Kappa has worked to establish a network of political and commercial connections throughout the Middle East and North Africa to identify other potential commercially attractive projects. The Syrian project has grown out of this initiative. In 1997, as the Yemen project has advanced to the stage of appraisal and exploration drilling, KAPPA had made new project development an equal priority.

Yemen Wadi

KAPPA's business plan is to establish an international producing base and grow the Company primarily through a balanced portfolio of technically and commercially attractive exploration projects that have both investor appeal and will attract participation from larger international operators. Development projects that provide both growth opportunities and strategic advantage for KAPPA will also be evaluated. KAPPA is now able to target high quality investment opportunities due to the broad international experience and technical and commercial expertise of its management team.

KAPPA is evaluating or pursuing projects in the following areas:

MIDDLE EAST

Republic of Yemen

KAPPA'S extensive expertise in the Yemen area puts it in an advantaged position to capitalize on other opportunities in the area. KAPPA continues to accumulate technical data from other blocks and monitor activity by other operators in Yemen.

Syrian Arab Republic

KAPPA has established excellent relations within the Syrian Oil Ministry and the Syrian Petroleum Company. KAPPA has been invited to evaluate a high quality exploration opportunity in the heart of the oil-producing region of the Euphrates Rift. A decision on whether to capture this opportunity will be made in the near future.

NORTH AFRICA

KAPPA has entered into an exclusive arrangement with a renowned international exploration consultant who specializes in North Africa and the Middle East, having an extensive data base and firsthand knowledge and expertise. This will allow KAPPA to target new opportunities in these areas on a technically driven basis.

NORTH SEA

KAPPA is looking to the North Sea for non-operated development or production opportunities with exploration upside as a possible initial international production base. The North Sea, particularly the UK sector, offers some of the most attractive commercial terms, falling development and operating costs on a dollar per barrel basis, and a politically stable environment as a balance for other third world locations where KAPPA is active.

LATIN AMERICA

Colombia

KAPPA is in negotiations with a Colombian operator for a majority working interest participation on two association contracts that it currently holds and a strategic alliance to pursue the recently announced development opportunities that will be released by Ecopetrol.

KAPPA will use the considerable Latin American expertise of its management team to consider expansion into other areas within Latin America in the future.

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and their accompanying Notes.

We believe that our commitment to fulfill our goals, combined with a strong KAPPA team, will build KAPPA into a successful international oil and gas company.

During 1996, KAPPA achieved the goals that it established, including:

- the completion of two equity financings which raised an aggregate $9.3 million,
- the finalization of all government and partners' approvals as operator and partner of the Yemen Block 2 concession,
- the creation of a public company with a strong investor base, and
- the establishment of strategic alliances that will lead to additional international projects.

These achievements position KAPPA for continued long term growth.

Acquisition of Keltey Energy Limited

On October 11, 1996, the Company completed a reverse takeover of Keltey Energy Limited ("Keltey"). This acquisition was accomplished with the issuance of 412,655 KAPPA shares for all the issued and outstanding shares of Keltey.

The reverse takeover was accounted for under the purchase method, as detailed in Note 3(a) to the Consolidated Financial Statements.

The Consolidated Financial Statements for 1996 include the Canadian oil and gas operations of Strasbourg Resources Limited, a wholly-owned subsidiary of Keltey, from October 11, 1996, the effective date of the acquisition.

Kappa's offices, Sana'a, The Republic of Yemen

Oil and Gas Operations

Oil and gas revenue of $51,412, operating expenses of $18,823, and depletion and site restoration costs of $37,454 relate to Canadian production acquired through the reverse takeover of Keltey. KAPPA expects to increase its oil and gas reserve base in 1997 either with a discovery from its Yemen Block 2 concession or through production acquisition in other countries.

Expenses

General and administrative and project development costs

As a result of KAPPA's first full year of operations, general and administrative costs in 1996 totaled $1.4 million. During the year, KAPPA increased its executive and administrative staff in Canada and relocated its corporate office to new premises.

In addition, these expenses include $562,500 project development costs incurred during the year in the pursuit of oil and gas projects in Egypt and the Syrian Arab Republic.

Surveyors with Yemeni crew

Amortization of capital and other assets

Amortization costs of $135,086 include the amortization of capital assets acquired during the year, incorporation costs, and start up costs deferred in 1995.

Liquidity and Capital R

KAPPA's liquidity and capital structure changed significantly during 1996 as a result of the two equity financings and the acquisition of Keltey Energy Limited.

Financing

In January 1996, KAPPA completed a private placement resulting in the issuance of 3,000,688 post-consolidation shares for $2.5 million. KAPPA's second private placement was completed in October 1996 resulting in the issuance of 5,109,755 post-consolidation shares for $6.8 million. The proceeds realized from these share issues will fund the company's capital expenditures and operations.

Capital Expenditures

KAPPA had an 80% working interest in Block 2 before payout and a 60% interest after payout. The remaining 20% working interest is held equally by two international partners.

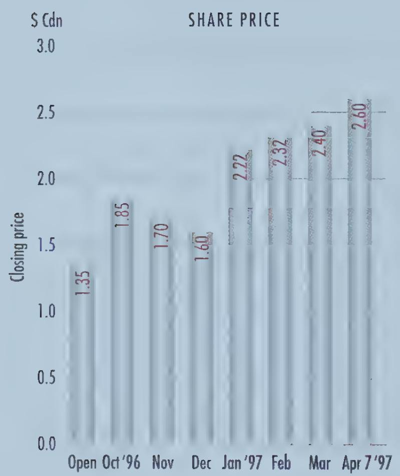
In 1996, KAPPA's Yemen Block 2 capital expenditure was $3 million funded by equity financing. In addition to securing all approvals for Block 2, the focus in 1996 was to conduct extensive geological and geophysical interpretation on Block 2 in preparation for the Phase 2 work commitment.

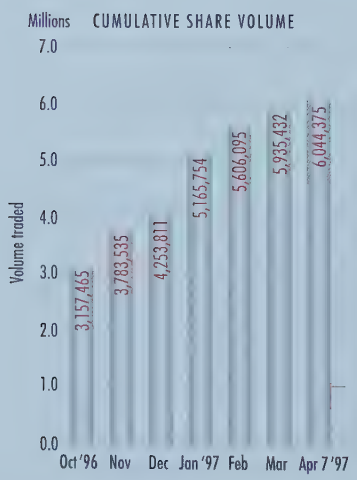
Subsequent to year end, KAPPA entered into a participating to farm out 20% of the Yemen Block 2 interest to an international partner. The agreement also includes option to buy back 10% of the concession.

KAPPA expects to raise additional funds through equity financing to complete its Block 2 work commitment and to acquire new projects in 1997.

Share Capital and Market Capitalization

The authorized share capital of KAPPA consists of an unlimited number of common shares, first preferred shares, and second preferred shares. As at December 31, 1996, there were 17.5 million shares issued and outstanding after the share consolidation. No preferred shares have been issued. The directors and officers of KAPPA own 31% (25% held in escrow) of the total issued and outstanding shares of the Company. During 1996, KAPPA'S common share price ranged from a low of $1.35 to a high of $2.60. The closing price at December 31, 1996 of $1.60 resulted in a year end market capitalization of $28 million. Subsequent to year end, KAPPA's share price traded as high as $2.75.





Business Risks

The international oil and gas industry is exposed to a variety of risks which include the uncertainty of finding new reserves, developing those reserves, interest and exchange rates, and changes of laws affecting foreign ownership. Management currently addresses these risks by:

- recruiting technical staff experienced in the international oil and gas industry,
- maintaining foreign currency bank accounts,
- maintaining debt at conservative levels,
- ensuring strong local management is maintained in local country offices
- obtaining stable joint venture partners for new projects,
- maintaining adequate international insurance,
- pursuing other projects.

Management, in conjunction with the Board of Directors, is currently in the process of formulating formal policies with regards to the identification and monitoring of the principal risks of the corporation.

Management's Responsibility For Financial Statements

Management is responsible for the integrity and objectivity of the information contained in this annual report and for the consistency between the financial statements and other financial operating data contained elsewhere in the report. The accompanying financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada using estimates and careful judgement, particularly in those circumstances where transactions affecting a current period are dependent upon future events. The accompanying financial statements have been prepared using policies and procedures established by management and reflect fairly the Company's financial position, results of operations and changes in financial position, within reasonable limits of materiality and within the framework of the accounting policies outlined in the notes to the financial statements.

Management has established and maintained a system of internal control which is designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and the financial information is reliable and accurate.

The financial statements have been examined by external auditors. Their examination provides an independent view as to management's discharge of its responsibilities insofar as they relate to the fairness of reported operating results and financial condition of the Company.

The Audit Committee of the Board of Directors has reviewed in detail the financial statements with management and the external auditors. The financial statements have been approved by the Board of Directors on the recommendation of the Audit Committee.

Rick Orman
Chairman and Chief Executive Officer

Angela Lau
Chief Financial Officer

Auditors' Report to the Shareholders of KAPPA Energy Company Inc.

We have audited the consolidated balance sheets of Kappa Energy Company Inc. as at December 31, 1996 and 1995 and the consolidated statements of income and deficit and changes in financial position for the year and the four-month period then ended, respectively. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1996 and 1995 and the results of its operations and the changes in its financial position for the year and the four-month period then ended, respectively, in accordance with generally accepted accounting principles.

BDO Dunwoody

BDO Dunwoody
Chartered Accountants

Calgary, Alberta
March 17, 1997

Consolidated Balance Sheets

December 31,	1996	1995
Assets		
Current		
Cash	$ 4,099,769	$ 2,050,235
Accounts receivable	671,330	103,644
Prepaids and other deposits	87,949	35,436
	4,859,048	2,189,315
Petroleum and natural gas properties (Note 4)	3,901,580	406,990
Capital assets (Note 5)	142,471	–
Other assets (Note 6)	–	162,291
	$ 8,903,099	$ 2,758,596
Liabilities and Shareholders' Equity		
Current		
Accounts payable and accrued liabilities	$ 1,155,144	$ 317,998
Income taxes payable	–	66,579
Due to related parties (Note 8)	–	598,100
Current portion of long term debt	60,000	–
	1,215,144	982,677
Long term debt (Note 7)	25,000	–
Accrued site restoration	3,500	–
Deferred share subscriptions	–	1,733,000
	1,243,644	2,715,677
Share capital (Note 9)	9,142,995	56,601
Deficit	(1,483,540)	(13,682)
	7,659,455	42,919
	$ 8,903,099	$ 2,758,596

Approved on behalf of the Board:

Rick Orman
Director

Byron J. (B.J.) Seaman
Director

Consolidated Statements of Income and Deficit

	Year Ended December 31, 1996	Four Months Ended December 31, 1995
Oil and gas revenue, net of royalties	$ 51,412	$ –
Expenses		
Amortization of capital and other assets	135,086	–
Depletion and site restoration costs	37,454	–
General, administrative and project development costs	1,403,290	13,682
Operating costs	18,823	–
	1,594,653	13,682
Loss before other items	(1,543,241)	(13,682)
Other		
Foreign exchange loss	(8,555)	–
Interest income	81,938	–
	73,383	–
Loss for the period	(1,469,858)	(13,682)
Deficit, beginning of period	(13,682)	–
Deficit, end of period	$ (1,483,540)	$ (13,682)
Loss per share	$ 0.1094	$ 0.0015
Weighted average number of shares, (Note 9) (post share consolidation)	13,435,833	9,002,063

	Year Ended December 31, 1996	Four Months Ended December 31, 1995
Cash resources provided by (used for)		
Operating activities		
Net loss for the period	$ (1,469,858)	$ (13,682)
Amortization, depletion and site restoration costs	172,540	–
	(1,297,318)	(13,682)
Changes in non-cash working capital balances		
Accounts receivable	(473,637)	(103,644)
Prepaids and other deposits	(52,513)	(35,436)
Accounts payable and accrued liabilities	794,534	317,998
Income taxes payable	(62,290)	66,579
	(1,091,224)	231,815
Financing activities		
Issue of share capital, net of issue and deferred financing costs	9,253,685	56,601
Deferred share subscriptions	(1,733,000)	1,733,000
Deferred financing costs	–	(77,915)
Due to related parties	(598,100)	598,100
	6,922,585	2,309,786
Investing activities		
Deferred start up costs	(1,914)	(77,840)
Petroleum and natural gas properties	(3,038,646)	(406,990)
Purchase of capital assets	(191,267)	–
Acquisition of subsidiary	(550,000)	–
Incorporation costs	–	(6,536)
	(3,781,827)	(491,366)
Increase in cash	2,049,534	2,050,235
Cash, beginning of period	2,050,235	–
Cash, end of period	$ 4,099,769	$ 2,050,235

December 31, 1996 and 1995

1. Nature of Operations

Since inception, the Company's efforts have been devoted to the acquisition and exploration of resource properties either directly or through joint ventures. The Company has not received any significant revenue from the sale of oil and gas resources. Accordingly, throughout the period of these financial statements, the Yemen Block 2 project costs have been considered as costs related to a new cost center in the pre-production stage.

The recoverability of amounts shown for petroleum and gas properties is dependent upon the discovery of economically recoverable reserves, continued confirmation of the Company's interest in the underlying concessions, the ability of the Company to obtain the necessary financing to complete the development and future profitable production or proceeds from the disposition of oil and gas properties.

2. Significant Accounting Policies

(a) Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries from their respective dates of acquisition. The subsidiaries whose accounts are included here are:

Kappa Energy Investments Inc.
Kappa Energy International Inc.
Kappa Energy (Yemen) Inc.
Strasbourg Resources Limited

(b) Petroleum and natural gas properties

The Company follows the full cost method of accounting for oil and gas operations whereby all costs of acquiring, exploring and developing oil and gas reserves are initially capitalized. Such costs include land acquisition, geological and geophysical expenses, carrying charges on non-producing properties, costs of drilling and overhead charges directly related to acquisition and exploration activities. All overhead relating to the Yemen operation cost center have been capitalized as this cost center is in the pre-production stage.

Costs capitalized, together with the costs of production equipment, are depleted and amortized on the unit-of-production method based on the estimated net proved reserves. Petroleum products and reserves are converted to equivalent units for the purposes of this calculation.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved resources are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the costs subject to the ceiling test. Proceeds from a sale of petroleum and natural gas properties will be applied against capitalized costs, with no gain or loss recognized, unless such sale would significantly alter the rate of depletion and amortization.

In applying the full cost method, the Company performs a ceiling test which restricts the capitalized costs less accumulated depletion and amortization from exceeding an amount equal to the estimated undiscounted value of future net revenues from proved oil and gas reserves as determined by independent engineers, based on sale prices achievable under existing contracts and posted average reference prices in effect at the end of the current year and current costs, and after deducting estimated future production related expenses, general and administrative expenses, future removal and site restoration costs, financing costs and income taxes. All of the Company's petroleum and natural gas exploration activities are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

(c) Deferred start up costs

The Company had initially capitalized business development expenses as start up costs. These have been amortized as the Company commenced active operations in 1996. Included were indirect administrative set up costs and travel costs related to the Yemen operations.

(d) Deferred financing costs

Financing charges paid by the Company are deferred and amortized over the life of the related debt instrument on a straight line basis. Financing costs paid in relation to equity issues are deferred and netted against proceeds from issue of related shares in the period that the equity issue is finalized.

(e) Capital assets

Capital assets are recorded at cost. Amortization is provided as follows:

Furniture and fixtures	20% declining balance basis
Computer hardware	30% declining balance basis
Computer software	100% declining balance basis
Leasehold improvement	3 year straight line basis

In the year of addition, assets are amortized at one-half of the above rates.

(f) Future site restoration costs

The Company accrues for site restoration costs on the basis of actual production. The accrual is based on management's best estimate of these future costs calculated on the rate of actual production to proved producing reserves.

(g) Foreign currency

Foreign currency accounts of the Company are translated into Canadian funds as follows:

- Monetary assets and liabilities are translated at year end exchange rates. Non-monetary items are translated at historic exchange rates prevailing at the date of acquisition.
- Revenue and expense items are translated at the average exchange rate for the year.
- Realized and unrealized foreign exchange gains and losses are included in operations except for unrealized gains or losses on long-term debt, which are deferred and amortized on a straight-line basis over the remaining term of the debt.

(h) Financial instruments

The Company's financial instruments consist of cash, accounts receivable, prepaids and other deposits, accounts payable, income taxes and a bank loan. Unless otherwise indicated, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

(i) Project investigation costs

Project investigation costs for new business opportunities are charged to earnings as incurred until such time as the commercial viability of the project is established. Subsequent expenditures are capitalized and amortized on a basis appropriate for the project.

(j) Accounting estimates

Trade accounts receivable include accruals due from joint venture partners for their proportionate share of expenditures incurred on the Yemen Block 2 concession. These amounts are based on determinations by management of expenditures that qualify for recovery pursuant to the terms of the Joint Operating Agreement in place with the joint venture partners. The nature and amount of the expenditures are subject to joint venture audits. As a result, the accrued receivables are subject to measurement uncertainty and the effect on the financial statements resulting from joint venture audits in future periods could be significant.

3. Business Combinations

(a) On October 11, 1996, the Company effected the purchase of Keltey Energy Limited ("Keltey") and its wholly-owned subsidiary, Strasbourg Resources Limited, via a reverse takeover. The acquisition has been accounted for by the purchase method with the Company being the deemed acquirer. Upon acquisition, Keltey was amalgamated with the Company. The consolidated financial statements include the accounts of Keltey at their historical values from the date of the acquisition as follows:

Current assets	$	90,304	
Capital assets		194,545	
Total assets		284,849	
Current liabilities		(141,901)	
Book value of assets acquired		142,948	
Value attributed to shares issued		(550,000)	
Purchase price discrepancy	$	(407,052)	
The excess has been allocated as follows:			
Financing costs	$	111,699	[1]
Capital assets		(613)	
Oil and gas properties		295,966	
	$	407,052	

[1] Included in share issue costs (Note 9)

(b) During 1995, the Company purchased Kappa Energy Investments Inc. ("Kappa Investments"). Kappa Investments was related to the Company by virtue of common control prior to the transaction. The consolidated financial statements include the accounts of Kappa Investments at their historical values from the date of the acquisition as follows:

Net book value of assets acquired	$	54,969
Purchase price paid		(1,000)
Purchase price discrepancy	$	53,969
The discrepancy has been allocated as follows:		
Incorporation costs	$	(1,100)
Capital assets		(38,969)
Oil and gas properties		(13,900)
	$	(53,969)

This transaction was effected to acquire the remaining oil and gas interest not directly owned by Kappa Energy (Yemen) Inc.

4. Petroleum and Natural Gas Properties

	Cost	Accumulated Amortization and Depletion	1996 Net Book Value	1995 Net Book Value
Canadian petroleum and gas properties	$ 489,898	$ 33,954	$ 455,944	$ –
Yemen Block 2 costs	3,445,636	–	3,445,636	406,990
	$ 3,935,534	$ 33,954	$ 3,901,580	$ 406,990

The capitalized Canadian petroleum and gas property expenditures are based on the value assigned to these assets as detailed in Note 3(a). The Yemen property, which is currently in the exploration stage, includes capitalized general and administrative costs relating to the Yemen operations of approximately $2,200,000 (1995-$70,000).

Yemen Block 2

Effective August 18, 1995, the rights to an 80% working interest in the Block 2 concession located in the area of Shabwa Province, south-central Yemen pursuant to an Earn-In Agreement dated June 10, 1995 were assigned to the Company. Under the terms of the Earn-In Agreement, the Company's 80% interest in Block 2 includes a capital expenditure to acquire 250 kilometers of seismic and to drill one well to prove up oil reserves. The Company is required to pay 80% of all costs before project payout, as defined in the Joint Operating Agreement, and 60% after project payout (Note 14(a)).

5. Capital Assets

	Cost	Accumulated Amortization	1996 Net Book Value	1995 Net Book Value
Furniture and fixtures	$ 54,840	$ 5,484	$ 49,356	$ –
Computer hardware	47,094	7,064	40,030	–
Computer software	64,078	32,039	32,039	–
Leasehold improvements	25,255	4,209	21,046	–
	$ 191,267	$ 48,796	$ 142,471	$ –

6. Other Assets

	1996	1995
Deferred start-up costs	$ 77,840	$ 77,840
Deferred financing costs	–	77,915
Incorporation costs	6,536	6,536
	84,376	162,291
Less accumulated amortization	(84,376)	–
	$ –	$ 162,291

7. Long-term Debt

	1996	1995
Demand loan, supported by corporate guarantees, bearing interest at prime, and repayable in monthly principal installments of $ 5,000 per month	$ 85,000	$ –
Less current portion	(60,000)	–
	$ 25,000	$ –

Principal payments due in the next two years are as follows:

1997	$ 60,000
1998	$ 25,000

8. **Due to Related Parties**

These were amounts due to certain directors and companies controlled by them either directly or indirectly. These directors are also significant shareholders of the Company. The amounts are non-interest bearing, unsecured and due on demand.

9. **Share Capital**

(a) Authorized

Unlimited number of Common Shares

Unlimited number of First Preferred Shares - rights, privileges, restrictions and conditions to be determined by directors at time of issue.

Unlimited number of Second Preferred Shares - rights, privileges, restrictions and conditions to be determined by the directors at time of issue.

(b) Issued

	1996		1995	
Common shares	Number of Shares	Amount	Number of Shares	Amount
Balance, beginning of period	15,000,000	$ 56,601	–	$ –
Issued for cash				
Private placements	13,544,440	9,335,552	15,000,000	56,601
Share consolidation [i]	(11,413,850)	–	–	–
Issued in exchange for the issued and outstanding share of Keltey Energy Limited	412,655	550,000	–	–
Share issue costs	–	(799,158)	–	–
Balance, end of period	17,543,245	$ 9,142,995	15,000,000	$ 56,601

[i] A 1.67 for 1 share consolidation was effected to facilitate the share for share exchange upon acquisition of Keltey (Note 3(a)).

(c) Stock options

The Company has stock options to employees and directors outstanding as at December 31, 1996, to purchase 886,004 common voting shares at an exercise price ranging from $0.83 to $1.33 per share vesting over a three-year period expiring September 2001.

(d) Warrants

The Company has warrants to directors outstanding as at December 31, 1996 to purchase 82,532 Common voting shares at an exercise price of $1.454 per share expiring April 19, 1998.

(e) Reserved Shares

The Company has reserved 60,014 Common voting shares as at December 31, 1996 to certain employees at an exercise price of $1.33 per share expiring September 3, 1997.

10. Related Party Transactions

Included in trade accounts payable is $Nil (1995 – $79,168) due to related corporations for expense reimbursements. These corporations are related by virtue of being controlled by directors and major shareholders of the Company.

Included in accounts receivable is a net amount of $104,943 (1995– $15,110) due from a member of the Company's management team in Yemen.

11. Financial Instruments

As disclosed in Note 2(h), the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to foreign currency risk, interest rate risk and industry credit risk. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

(a) Interest rate risk management

The Company has limited exposure to interest rate risk due to the current availability of cash. The floating rate debt is subject to interest rate cash flow risk, as the required cash flows to service the debt will fluctuate as a result of changes in market rates. As at December 31, 1996, the Company had variable interest rates on 100% (1995 – N/A) of its long-term debt obligations at an effective rate of bank prime. However, the related interest rate cash flow risk is not material to these financial statements.

(b) Foreign currency rate risk management

A significant portion of the Company's operations are located in Yemen and, accordingly, the related financial assets and liabilities are subject to fluctuations in exchange rates. The Company does not have any exposure to highly inflationary foreign currencies.

The Company manages its exposure to foreign currency fluctuations by maintaining foreign currency bank accounts and foreign currency receivables to offset foreign currency payables. In addition, the Company denominates its commitments and contracts in US dollar equivalents. At December 31, 1996 approximately $3.8 million of the cash on hand was being held in a Canadian dollar account at one Canadian chartered bank.

(c) Fair market value

The carrying values of cash, receivables, payables and accrued liabilities approximates their fair value. Accrued recoveries from joint venture partners included in accounts receivable are subject to measurement uncertainties as detailed in Note 2(j).

(d) Credit risk

A significant portion of the Company's trade accounts receivable arise from recoveries from joint venture partners pursuant to the terms of existing joint operating agreements. The significant joint venture partners are foreign entities involved in the oil and gas industry, and as such, the Company is exposed to all the risks associated with that industry.

12. Commitments

(a) At December 31, 1995 there were letters of credit outstanding payable in the favour of Crescent Petroleum (Yemen) Inc., the company with which the Earn In agreement was entered into (Note 4) in the amount of US$500,000 dollars. During 1996 these letters of credit expired.

(b) The Company is committed, under the minimum work requirements of the Production Sharing Agreement, to acquire 250 kilometers of seismic data and to drill one well by May 1998.

(c) The Company is committed to the following property and equipment lease commitments over the next five years:

1997	$ 127,660
1998	76,252
1999	76,252
2000	17,952
2001	6,252

(a) At December 31, 1996 the Company had entered into employee and management contracts for a minimum 1997 compensation of approximately $112,000.

(b) During 1996 the Company entered into consulting agreements with independent consultants in the Middle East that commits the company to pay fees of US $41,000 per month expiring at varying dates to May 1998. The consultants also received signing bonuses of US $160,000. In addition, these consultants are entitled to certain performance bonuses based on project expenditures to be incurred on the property.

13. Contingent Liability

The Company and an industry partner entered into a conditional agreement in 1995 with Crescent Petroleum (Yemen) Inc. ("Crescent") pursuant to the terms of which the industry partner was to participate as to a 20% interest of the concession and as a member of the Yemen Block 2 joint venture. Such participation would have reduced the Company's working interest in the concession from 80% to 60%. This industry partner was not approved as a participant and operator of the concession by the Republic of Yemen Ministry of Oil and Mineral Resources and it is the position of Crescent and the Company that the industry partner did not meet the fundamental conditions to acquire any right to an ownership interest.

Despite their non-approval as a participant, it is the industry partner's position that they continue to be entitled to certain interests in the Yemen Block 2 concession. In management's view, this dispute will be resolved in the Company's favour. Notwithstanding the industry participant's position, the Company has accounted for the participant's share of expenditures to date.

14. Subsequent Events

(a) Subsequent to year end, the Company entered into an agreement to farm out 20% of the Company's interest in the Yemen Block 2 concession. This transfer is subject to the final approval of the Republic of Yemen, the existing joint venture partners and The Alberta Stock Exchange. In consideration on this assignment the participant will be responsible for a payment of US $100,000, and 26.66% of costs and expenses incurred under the terms of the existing joint operating agreement and the production sharing agreement on the Yemen Block 2 concession until payout.

The Company has retained an option to re-purchase one-half of the interest being farmed out herein (i.e. 10% of the Yemen Block 2 concession) for a fixed purchase price of 1,800,000 common shares of the Company. This option expires no later than September 30, 1997. Upon the exercise of this option the Company has agreed to reimburse the participant for 50% of costs incurred by the participant to the exercise date.

(b) Subsequent to year end, the Company entered into a joint participation agreement with the aforementioned participant pursuant to the terms of which the participant is to pay an initial fee of US$ 250,000 and 50% of ongoing project investigation and related costs incurred in the Syrian Arab Republic.

In addition to the foregoing, the participant has agreed to provide the required standing letters of credit and in return therefore will earn the right to participate 50% in all opportunities pursued and operations contemplated in the Syrian Arab Republic.

15. Segmented Information

Industry Segments:
The Company operates in one industry segment, the oil and gas industry.

Geographic Segments:
During 1996 the Company began significant operations in another geographic segment, Canada:

	1996
Revenue:	
Canada	$ 51,412
Middle East	–
	$ 51,412
Loss before income taxes:	
Canada	$ (643,563)
Middle East	(826,295)
	$(1,469,858)
Identifiable assets:	
Canada	$ 4,555,470
Middle East	4,347,629
	$ 8,903,099

The Company's principal business segment is the acquisition, exploration and development of oil and gas properties. All of the Company's foreign properties are in the exploration and development stage and therefore those exploration costs are deferred.

16. Income Taxes

Income taxes reported differ from the amount computed by applying the statutory income tax rates to income before income taxes. The reason for these differences and their tax effects are as follows:

	1996	1995
Statutory tax rate	44%	44%
Income taxes at the statutory rate	$ (646,700)	$ (6,020)
Unrecognized benefit of loss incurred in foreign jurisdiction	325,300	–
Future benefit of loss carry-overs not recorded	315,200	6,020
Permanent differences	6,200	–
	$ –	$ –

The Company currently has approximately $730,000 of Canadian loss carryover balances expiring in 2002 and 2003. In addition, the Company has undeducted capital costs, oil and gas pools and deferred financing cost pools approximating $890,000 to deduct against future Canadian taxable income. The tax pools available to the Company pursuant to the production sharing agreement with the Yemen Ministry are currently not determinable.

CORPORATE INFORMATION

Founding Shareholders

Rick Orman
Chairman and Chief Executive Officer, KAPPA Energy
Former Member of the Alberta Legislature and Minister of Employment, Minister of Labour and Minister of Energy

Michael Kanovsky
Co-Founder and Director of Northstar Energy Corporation; Chairman of Taro Industries

Angus Mackenzie
Founder of Syracuse Oils and Sunningdale Oils; formerly Chairman of Sceptre Resources Limited. Founder, former Chairman and Operating Partner of Dugas, Dubai, UAE

Jim Palmer
Senior Partner, Burnet Buckworth & Palmer; Chairman, Telus Corporation; Director (retired), Bank of Canada

Gerald Regan
Businessman and Lawyer; former Premier of Nova Scotia; Government of Canada Energy Minister

Daryl (Doc) Seaman
Byron (B.J.) Seaman
Donald Seaman
Founders of Bow Valley Industries; directors of several Canadian companies

Board of Directors

Rick Orman
Chairman and Chief Executive Officer, KAPPA Energy

Angus Mackenzie
Director

Michael Kanovsky
Director

Byron (B.J.) Seaman
Director

Grant Emms
appointed Director March 1997

Officers

Rick Orman
Chairman and Chief Executive Officer

Grant Emms
President and Chief Operating Officer

Angela Lau
Chief Financial Officer

Kamal Ataya
Chief Operating Officer, KAPPA Energy International Inc.; President, KAPPA Energy (Yemen) Inc.

Key Personnel

James Bryan
Deputy General Manager
Sana'a, Republic of Yemen

Debbie Bottomley
Investor Relations Manager

Penny Nakahara
Executive Adminstrative Manager

Douglas Hirsch
Executive Adminstrator

Auditors

BDO Dunwoody
Calgary, Alberta

Legal Counsels

Burnet, Duckworth & Palmer
Corporate Counsel
Calgary, Alberta

Felesky Flynn
Tax Counsel
Calgary, Alberta

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International Counsel
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